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SUBJECT: INFLATION STABLE, BUT PRICE PRESSURES INCREASE AS
IRAQ REBUILDS

REF: BAGHDAD O/I 02/04/08

¶1. (SBU) Summary: The latest official data show a small decline in Iraq's consumer prices in May. The annual rate of core inflation now stands at 14.7 percent, close to its average level over the past year. Inflationary pressures are likely to rise in coming months as Iraq's economy runs against supply constraints in key sectors such as construction. End summary.

¶2. (U) According to GOI price data released June 18, the broad consumer price index (CPI) declined by 1.3 percentage points in May. The core price index, which excludes the most volatile elements of the CPI, fell by 1.9 percentage points for the month. As a result, the latest 12-month broad measure of inflation is 4.6 percent, nearly a full point lower than the April figure of 5.5 percent. Annual core inflation now stands at 14.7 percent, a shade lower than its average level of 15 percent over the past 12 months.

¶3. (U) May's marginal drop in the inflation rate comes after an expected spike in April inflation due to violence-related marketplace closures in Baghdad and Basra (reftel). The latest CPI results are further evidence that inflation in Iraq has stabilized, even though global food prices for food and energy have increased sharply.

¶4. (SBU) But the latest Iraqi price data also show growing upward pressure on prices for non-tradeable goods such as transportation, housing, and construction materials. The price index for non-tradeables has increased 12.7 percent over the past 12 months, almost three times more than the CPI. At a June 11 conference on budget execution, a full week before the latest CPI release, Central Bank Deputy Governor Ahmed Ibrahi said Iraq's economy is approaching the limits of its productive capacity in some sectors, especially construction. Ibrahi said the cost of construction was rising as new projects exhausted supplies of construction materials. He also noted strains on the capacity of the relatively small number of competent building firms in Iraq.

¶5. (SBU) Comment: Rising prices for non-tradeable goods can be taken as a positive indicator of economic recovery in Iraq. The GOI's focus on budget execution should boost aggregate demand, and improved security gives the private sector more scope for spending on rebuilding and improving homes and businesses. These two factors probably account for the tightening of supply conditions in construction. If Ibrahi is right in saying that Iraq's non-oil economy is close to supply limits in some sectors, then accelerated GOI spending could mean even more upward pressure on prices. With the GOI preparing a supplemental budget emphasizing capital expenditure, we should expect inflationary pressure to grow in the coming months. But increasing fiscal stimulus should also translate into more employment and income, both of which are central to our counter-insurgency strategy.

CROCKER